

GEORGIA MARKET REFORM AND AGRICULTURE ASSESSMENT

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GEORGIA MARKET REFORM AND AGRICULTURE ASSESSMENT

I. Executive Summary

A. Background

USAID/Georgia's market reform program has reached a key turning point. Since its violent emergence from 70 years of Soviet rule in the early 1990s, Georgia has experienced significant success in developing the basic infrastructure for a strong private sector, including land titling, capital market development, and enterprise privatization. As a result, modest economic growth continues (at around 4.5 percent per annum so far in 2000).

Here was the country I had grown so much to like, with its wild mountain dances, devil-may-care dramas, prising open the fist of stone fixed around itself for 70 years only to find it shattering. In its place out burst a thousand small fists and dances. Waving and shouting louder than any before.

- Peter Nasmyth, from Georgia in the Mountains of Poetry

However, the Georgian Government is also in an unprecedented state of fiscal crisis fueled by the country's endemic corruption. Furthermore, this fiscal crisis is aggravated by Georgia's skewed distribution of income (among the highest in the world) and isolation from international trade (with merchandise trade at only 10 percent of purchasing power parity GDP).

Aggressive policy and regulatory reforms are a vital, but not sufficient, means of breaking this vicious cycle. Growth must bring economic opportunity to more than the privileged few. Local and foreign investors must overcome prohibitively high information and transactions costs to establish efficient market and value "chains" along which primary producers, suppliers, processors and traders can operate reliably.

USAID now has the opportunity to protect (and in fact significantly amplify) the gains from reform realized so far. It can do so by promoting, in a limited set of promising industry areas, direct outreach to firms and inducements to establish competitive, forward- and backward-linked, industry clusters that can expand Georgia's domestic and export earnings.

Perceiving this window of opportunity, USAID/Georgia saw this assessment as an occasion to gather both Mission staff and their key "virtual" team members from the Europe and Eurasia Bureau's Market Transition Office (E&E/MT) to evaluate the program and its ability to capitalize on this evolving situation. The team, comprised of E&E/MT specialists in the macroeconomic, financial, enterprise and land privatization, agricultural/agribusiness and micro/small-medium enterprise areas, collaborated closely with USAID/Georgia's Economic Reform Strategic Objective Team in preparing this report. The team was repeatedly urged to consider any aspect of the existing program as open to question. As a result, the assessment team believes that this report offers a set of suggestions from which the Mission could further focus, and in some instances redirect, the program to take maximum advantage of the opportunities now inherent in Georgia's relatively dire – yet promising – current situation.

In summary, the time appears propitious for a dual thrust in USAID/Georgia's economic reform program:

- First, **focus, concentrate and selectively accelerate the pace of reform** (particularly in the fiscal and government restructuring areas).
- Second, **create more vibrant markets for both land and agricultural products** in order to enable the nation's considerable agribusiness potential to respond to the gradually improving business/economic climate.

B. Summary of Recommendations

Three key adjustments to the USAID/Georgia economic reform program emerge from the team's findings:

1. **Strengthen fiscal reform** by enhancing the existing, tax administration reforms with further efforts aimed at:
 - a. continuing legal drafting efforts to simplify the tax code and to amend the tax code;
 - b. considering exempting agriculture and agricultural inputs from most of the many layers of taxation that present a particular deterrent to foreign and domestic investment in this key sector;
 - c. seeking targets of opportunity to control public expenditures more effectively; and effectively creating and administering a Treasury function in the Government that separates the payment of government officials from any subjective government budgeting;
 - d. completing efforts at internal control within the Tax Ministry and the Large Taxpayer Inspectorate; and
 - e. exploring means to restructure radically the deeply flawed customs service.
2. **Initiate corporate strengthening** by concentrating and furthering initial efforts at market reform from basic corporate functions to integrated and viable enterprise performance. This will occur through the institution of International Accounting Standards and by providing assistance from newly established structures to a more integrated effort aimed at assisting market-oriented enterprises. These efforts will evolve institutional development in Georgia from the past two years into a hybrid approach to provide:
 - a. local consulting to enterprises to develop good financial cost and management reporting and disclosure practices;
 - b. marketing research and enterprise business planning that will provide for periodic reporting and enterprise disclosure of annual reports and quarterly statements that are independently audited;

- c. assistance in financial and physical plant restructuring of enterprises and tax forgiveness of pre-market reform era obligations;
- d. establishment of investment fund institutions and initial public offerings of pilot enterprises in order to raise capital and exercise shareholder rights; and
- e. alongside the continued development of the banking infrastructure (bank supervision legal and regulatory reform, bank accounting reform), modest additional assistance to support the implementation of commercial law should be provided.

3. Enable vibrant land and agricultural/food product markets to emerge by:

- a. strengthening the Association for the Protection of Land-owner Rights (APLR) to complete issuing of land titles and then facilitating the formation of efficient markets for the sale and resale of land parcels; and
- b. launching a new three to five year assistance activity, initially with a \$3 to 4 million funding tranche, to establish privately owned and operated farm stores and agribusiness service centers to promote profitable agricultural and agri-processing product/market/value chains for both domestic and foreign markets.

In the report's Section II below, the team presents its findings and recommendations that support the above conclusions. The annexes contain a chart indicating the specific portfolio adjustments that would be required, as well as a list of those whom the team contacted during its three weeks' work in Georgia.

II. Key Elements of USAID/Georgia's Economic Reform Program

There are two fundamental thrusts to USAID/Georgia's strategy to encourage the transition from a centrally planned economy to broad-based economic growth in a relatively free-market economy.

- **The first thrust involves reforming the enabling environment** -- the set of policy, regulatory and administrative reforms of government and private industry needed to create the conditions under which private enterprise can thrive and the fundamental interests of consumers and investors can be protected. This thrust embraces the bulk of USAID/Georgia's economic assistance activities to date.
- **The second thrust consists of working directly with firms, producer groups and individual microentrepreneurs and farmers** to stimulate production, marketing, processing, service provision, or other economic activity that offers employment and earnings opportunities for Georgians (particularly those who are economically disadvantaged). In this latter area, USAID/Georgia's support of micro- and small/medium enterprise promotion -- through various non-governmental organizations (NGOs) and in the new contract with Sibley International and its partners under the Georgia Enterprise Support Program -- are perhaps the best examples.

The Assessment Team believes that the fundamental adjustment to USAID/Georgia's program at this juncture may consist of a combination of measures that, in toto, have the effect of enhancing USAID's direct impact on the enterprise/entrepreneur level. The recommended measures would also strengthen the market and product value chains that permit individuals and groups to benefit more fully from the gradually liberalizing economic climate.

The team's findings and recommendations below address both of these strategic thrusts.

A. Reforming the Enabling Environment

To improve Georgia's enabling environment for private enterprise, USAID has appropriately focused on four key program areas:

- macroeconomic reform (particularly in governmental tax, customs and expenditure-control);
- enterprise privatization (involving the full range of large and small state enterprises);
- land privatization (including both urban and rural land); and
- financial markets and corporate governance (including reforms in banking, applying international accounting standards and enterprise viability).

The team's recommendations on each of these topics follow.

1. Macroeconomic Reform:

a. Macroeconomic Context

Georgia's economy continues to grow. In 1996-1997, economic growth was roughly 11% annually, slowing considerably in 1998-1999 to about 3%; early estimates of 2000 have it so far around 4.5%. There is also monetary stability. There was effectively no inflation from the beginning of 2000 through end-May, maybe even some deflation. And the exchange rate has been stable.

However, while economic growth has been moderate to robust, the distribution of the gains has been exceptionally unequal. Income inequality in Georgia is among the highest in the transition region and among the highest in the world in fact; comparable to that found in some of the most unequal economies of Latin America and Sub-Saharan Africa.

i. Corruption

Corruption has certainly played a role in this highly skewed income distribution. Some are getting very rich in the current (corrupt) system, most are just getting by. Corruption is endemic and widespread. Cross-country comparisons show that corruption in Georgia is among the worst in the Europe/Eurasia transition region and among the worst worldwide. Transparency International's 1999 Corruption Perceptions Index shows that Georgia ranks 84th out of 99 countries worldwide in the degree to which corruption is perceived to exist among public officials and politicians; for the transition region, it ranks 18th out of 24 countries. It's worth noting, however, that while it may be a fundamental problem in Georgia, it is a problem that is not unique to the transition region. In fact, corruption is perceived to be a greater problem in a handful of other countries, including Azerbaijan, Uzbekistan, and Kyrgyzstan; and by these measures, Georgia's corruption is on par with that found in Kazakhstan and Albania.

Corruption flourishes in part because Georgia lacks a government that is able to set the rules and establish a level playing field. Consequently, the economy suffers from inefficiencies (with much economic activity occurring unofficially), overseen by a government without sufficient authority and credibility; a government that is not only unable to establish the rule of law, but is unable to play the critical role of distributing the gains among society. The economy then is caught in a sort of "low-level equilibrium" characterized by "vicious circles."

ii. Fiscal Problems

At the core of Georgia's present macroeconomic predicament are the financial difficulties of the government, which have set the pattern for the economy as a whole. Tax revenues as a percent of GDP (roughly 10%) are among the lowest in all the transition countries. Expenditure arrears, mostly in wages, pensions, and social benefits, have been accumulating for several years and now stand at roughly 5% of GDP. Arrears on external debt principal payments reached 115% of gross reserves at end-March 2000.

Roughly half of the tax revenue that could be raised at existing tax rates is foregone. (The lowest tax compliance is the with taxes collected by Customs, at 30%.) This stems in large part from corruption and tax evasion and a large informal economy. Smuggling, particularly of petroleum products, cigarettes, and ethyl spirits, is widespread, especially where the central government has little authority such as in Abkhazia, Ajara and South Ossetia. Much of the challenge stems from the

existence of a vicious circle with expenditure arrears and tax revenues: the state does not get enough tax revenue to pay its staff a living wage, and state employees in turn seek bribes to supplement their meager wages. This form of "informal" taxation keeps government revenues low and businesses and individuals in the informal economy. Most estimates of the informal economy in Georgia show it to be among the highest of the transition countries as a percent of the official economy, anywhere from 40% to 60% of GDP.

Expenditure leakages are also a significant problem. Soft budget constraints are widespread. The IMF reports that only 20% of the 600 largest taxpayers pay taxes due in full and on time. There is foregone tax revenue from some state-owned enterprises as well; in general they do not submit dividends or profits to the budget. However, it should also be noted that team visits to a sample of enterprises confirmed that many are not operating and have no revenues to be taxed. While many are not profitable, enterprises which could pay tax revenue include those in infrastructure and energy (ports, railways, airport, local and international telecommunications, natural gas transit and distribution, and oil extraction). Note: all are in debt, and with the exception of gas, telecoms and oil, will never be commercially viable.

iii. Integration into the Global Economy

One key means of improving economic efficiency and productivity is to integrate more fully into the world economy. This is critical for any country, but more so for a very small one. Georgia's economy is among the smallest of the transition countries, perhaps less than 2% of the Russian economy, to put it in some perspective. While Georgia scores relatively high in trade reforms and trade liberalization, it remains relatively autarchic. Its trade sector is among the smallest in the transition countries, comparable to Albania and a handful of others; its merchandise trade has only been about 10% of purchasing power parity GDP. Georgia does not produce much that is competitive in the world markets. Its principal exports in 1999 were metals (24% of total exports), much of this scrap metal. (From January-May 2000, scrap metals were the largest commodity exports, at 12% of total exports). Once a major agricultural exporter, Georgia is now a net importer of basic food commodities. Georgia's wine, tea, fruit, nut and other agricultural products still rank second only to metals, at over 17% of total exports. Partly reflecting this inability to compete have been the large, seemingly unsustainable, current account deficits, which have not been below 6% of GDP since the transition began.

Russia remains Georgia's main trading partner, though the crisis in Russia contributed significantly to at least temporarily reducing Georgian exports to Russia. In 1994, 34% of Georgian exports went to Russia. By 1999, this proportion was reduced by almost one-half, to only 19%. Early estimates of 2000 trade patterns show some rebound in the proportion of exports to Russia, 21%.

In addition, foreign direct investment (FDI) remains insignificant. On a per capita basis, FDI fell from \$44 in 1998 to \$19 in 1999, below the Eurasian average of \$24, and far below CEE standards (where in the Northern Tier CEE it was \$178 in 1999). According to one source, total fixed capital investment in Georgia (i.e., domestic and foreign) fell 57% in 1998 and by 28% from first quarter 1999 to first quarter 2000, largely because of the cessation of pipeline construction.

Georgia's external debt and debt service are among the highest of the transition countries. Total external debt in 1998 was 353% of exports. By this measure, only Armenia and Albania are further

in debt. Total debt service increased from 17% of exports in 1998 to 22% in 1999, one of the highest proportions in the transition region.

v. Economic Reform Progress

It may be helpful to put much of the aforementioned challenges in a wider context. Economic reforms (alongside democratic reforms) have been moving forward in Georgia in recent years. Moreover, while Georgia has far to go, its economic reform progress is in the middle of the pack of the Eurasian countries. By EBRD measures, Georgia ranks 6th out of 12 Eurasian countries and 18th out of all the 27 transition countries in progress in economic reforms, slightly behind Russia and Armenia, and slightly ahead of Ukraine and Albania.

Progress in most of the easier "first stage" economic reforms (in particular, small-scale privatization, trade and foreign exchange reforms, and domestic price liberalization), is farther along in Georgia, and is comparable to some CEE countries (Macedonia most closely). Small-scale privatization is essentially complete: some 12,860 small-scale enterprises were privatized between 1993-1998; 80% of these in the trade and services sector. Georgia is only the second Eurasia country (behind Kyrgyzstan) to attain WTO membership, evidence that it has one of the most liberal and open trading systems within Eurasia.

Progress in Georgia in legal reforms (both extensiveness and effectiveness), in contrast, rates among the lowest of all the transition countries by EBRD scores. Overall, while there has been some progress towards the legal and regulatory framework for a market economy, informal (regional, personal, and clan-based) networks persist. Moreover, until the rule of law is more firmly established [and reform laws are actively implemented and enforced], robust formal sector growth will likely remain elusive and tax collections at an extremely low level relative to the size of the economy.

Progress in "second stage" reforms in Georgia (including large-scale privatization, financial markets reforms, competition policy, and policies towards improving corporate governance) is average for Eurasia. Large-scale privatization is well advanced, closer to Northern Tier CEE norms than Eurasian. Roughly 75% of the medium and large-scale enterprises (950 out of 1,250) have been privatized by end-year 1999 (50 such firms in 1999). The reorganization and privatization of the electricity sector is well advanced in comparison to other countries in Eurasia, and privatizations of telecommunications are expected to proceed in late 2000. Highlights include the privatization of the Tbilisi area electricity distribution enterprise (in January 1999), the Gardabani thermal generation plant in Tbilisi (January 2000), and several other small electricity distribution enterprises.

b. Fiscal Reforms: Tax, Customs and Public Expenditure

Addressing the government's fiscal problems needs to be the highest priority for donors. The expenditure arrears and government's soft budget constraints set the pattern for the entire economy. The challenge is to do the reforms in a way that meets short-term (fiscal) needs while laying the foundation for longer-term (development) imperatives. This means that tax reforms need to be done in a way that increases government revenues with an eye towards also encouraging investment and private sector economic activity. In addition, managing expenditures needs to be done in a way that minimizes social costs; i.e., how and where expenditures are cut is key. Clearly these matters must

be addressed in unison with the IMF's and the World Bank's ongoing efforts.

The current task order for USAID/Georgia's (Phase II) Fiscal Reform Program with Barents extends through September 2001, and will cost about \$6.9 million, which includes \$1.5 million of computers for the tax administration. The U.S. Treasury Department is also providing some assistance in fiscal reform. The main components of the task order are tax administration (including computerization and training), tax policy (writing regulations for the main taxes), macroeconomic assistance to the Ministry of Finance (revenue forecasting) and budgetary assistance to the Parliament.

i. Tax and Customs Administration

It is widely recognized that most of the focus towards decreasing the fiscal deficit needs to be on improving tax administration and enforcement. Roughly one-half of the tax revenue that could be raised at existing tax rates is foregone. Moreover, tax revenues have been relatively inelastic to changes in tax rates. Primarily as a consequence of the dismal record of collecting tax revenues, government expenditure arrears have mounted, and now stand at roughly 5% of GDP. The social costs of these arrears have been high; the relatively disadvantaged segments of the population have been hit hardest by the spending cuts and non-payments.

(a) Tax Department Reorganization

The main focus of USAID's fiscal reform program is the reorganization of the tax department. This focus is well-placed. The implementation of this reform was delayed because of delays in signing the Memorandum of Understanding (between the governments of Georgia and U.S.). It was also held back by changes in the government of Georgia (the Ministry of Revenue was created and its minister empowered, eventually, with the authority to follow-through on the reorganization). However, the implementation plan is moving forward and appears to be reasonably on target. The MOU was signed in March 2000. The groundwork has been laid in several aspects. This includes the development of a training curriculum to assist new staff with their functionally organized duties. The Tax Administration Computer System (TACS) is installed in three pilot offices. A public education campaign to increase public awareness and support for the reforms has been developed.

As part of the staff reduction process, the first round of testing of tax department employees begins in August 2000. Barents estimates (and others agree) that the re-organization of the tax departments in Tbilisi can be completed by end-December 2000, and that the reorganization of the tax departments in the rest of the country can be completed, as originally planned, by September 2001. In any event, the process has essentially just begun.

Overall, the plan is well-conceived and appropriately ambitious. The process incorporates appropriate incentives or conditions ("accreditation phases") to encourage results along the way. The political will to make the difficult changes appears to exist. Both the Minister of Revenue and the Minister of Finance are supportive and appear to have a firm grasp of the urgency and of the appropriate priorities.

While we have no suggestions to change the current plan, it should be noted that there will be a need for some follow-on activities to sustain and further the reforms. The computerization at the end of the current activity, for example, will not be complete. Additional functions will need to be

installed, such as additional modules to cover all the taxes (the current computer modules will cover only the four main taxes). Further computerization will be needed for audit selection, and additional

collection functions will likely be needed, such as prioritizing collections based on such factors as age of arrears. This computerization, however, would require a follow-on activity beginning in FY 2002.

Recommendation:

- **Stay the course. We should know by December 2000 if the Tax Department re-organization has had a substantial impact. We will also know by then if the government has been successful in meeting the conditions for a resumption of a formal program with the IMF.**
(b) Customs Administration

It is doubtful that the government of Georgia can significantly raise tax collections without addressing the issue of low collections by Customs. Roughly half of total tax revenue should be coming from Customs. Yet tax compliance, at 30%, is abysmally low from Customs. Moreover, Customs collections appear to be getting worse, in contrast to tax collection trends in the Tax Department (which has made some improvement in tax collections over the past year). Large amounts of gasoline and diesel are being smuggled into Georgia and there seems to be a lack of will on the part of Customs to tackle this issue. In fact, in recent months, these collections have dropped precipitously. Tax avoidance by these taxpayers creates serious problems for legitimate businesses that have difficulty competing with the lower prices of smuggled goods.

Customs needs an overhaul similar to what is being tried in the Tax Department, including an infusion of “new blood” in the ranks and new management. Despite the consequences of inaction, no major donor has yet been willing to step forward to take the initiative to reform Customs. U.S. Customs does currently have a program with Customs (focused primarily on border guards). However, the consensus is that it is neither well equipped nor free to perform its duties to the full extent of the law. USAID may wish to consider complementing or supplementing assistance from the U.S. Customs Service in order to enhance overall impact of the U.S. assistance effort in this vital area.

It is widely recognized that reforming and restructuring Customs will be more difficult than doing the same in the Tax Department. Corruption is greater in Customs. There is more money involved and more powerful vested interests in various smuggling clans. Most argue that the current Customs leadership is not receptive to change. Some argue, hence, that now is not the right time to affect change. Moreover, the challenge of reforming Customs may be linked to a wider issue, of territorial conflicts and sovereignty, and hence is very politically charged.

Intertek Testing Services (ITS), a U.K consulting firm, has invested \$1 million in anti-smuggling efforts, largely through the implementation of a pre-shipment inspection (PSI) program. It has met with some success, and has proposed a restructuring of Customs similar to that of the Tax Department. The Assessment Team's discussions with Neville Bissett of ITS revealed a more optimistic perspective than most on the possibilities for effective change in Customs. He estimated, as underscored in the July 2000 ITS business plan, that it would take roughly \$3.5 million to implement the necessary institutional reforms of Customs.

At the request of the government of Georgia, both the World Bank and the IMF are once again independently conducting assessments of Customs to determine the scope of the problem and presumably a game plan for action. These assessments should be forthcoming before year's end. Neither these assessments, nor the various concerned donors, however, are well coordinated on this

problem at this point.

Recommendations:

- **At the least, USAID/Georgia should take some initiative to increase the visibility of this issue. One option would be to form a high-level, highly visible committee that would include the major donors and senior parliamentary and GOG officials.**
- **Consider using the tax department re-organization as a model for action, depending on results in the coming months of that plan. The forthcoming assessments from the World Bank and IMF should also guide action.**

ii. Tax Policy

Tax policy, alongside how it is administered, is a significant obstacle to business development. First, the overall tax burden is high. There are too many taxes, especially "nuisance" taxes such as the road fund. Social taxes are burdensome and are not used ineffectively. Presumptive taxation should be instituted to simplify and add transparency to the collection process.

Second, the tax code is continually being amended. It has undergone sixteen major amendments, in fact, since it was adopted in 1997. Third, there are too many kinds of taxes; the tax system is much too complicated. So complicated and fluid is the tax regime that businesses, particularly SMEs, and farmers are generally unable to comply even if they have the financial means and the will. Moreover, there is little means by which enterprises and taxpayers can get access to the tax information that they need.

These factors, combined with the frequent harassment from the highly corrupt tax agencies, result in frequent and burdensome fines for noncompliance for the small businesses and farmers. The interest rate for late payment of taxes is high, an annual rate of over 70%. In fact, the interest and penalties can end up being more than the tax, and can put a taxpayer out of business, as evidenced by enterprises the team visited.

What is needed then are fewer changes to the tax code. The tax reform implementation plan for the Tax Department proposes a system whereby amendments to tax law are allowed once a year, as part of the budget formulation process. This makes sense. As part of this, there may be a need for some oversight in Parliament to prevent tax code amendments from being introduced.

In addition, taxes need to be simplified. Changes that would simplify the system that are, by and large, revenue neutral should be considered. Tax simplification helps at both "ends;" for the small business and/or farmer who lacks the capacity to comply to a more complicated system, as well as the tax department which does not have the capacity to audit and collect taxes from more sophisticated systems (like the profit tax, etc.).

Consideration should be given to a presumptive tax on all small businesses to replace most if not all other taxes. Similarly, tax simplification for farmers should be considered. By one count, there are up to ten different taxes imposed on agriculture in Georgia, including an entrepreneur tax, a traffic fund, a dividend tax, unemployment fund, and so on. The simplest system, and hence perhaps the best, would be a flat land tax that would take the place of most if not all taxes on farmers. In

addition, consideration should be given to take this one step further; namely phase in this tax over several years, perhaps three to five years. Except for the land tax, tax revenues from farmers are negligible (most farmers are simply unable to pay and/or pay an “informal” tax in a bribe instead), and so revenue losses to government will be minimal. A tax holiday for farmers could also give an added incentive to produce, which in turn should generate additional tax revenue in the future.

A land tax is superior to other taxes in the sense that it does not distort decisions about investment and labor input. Moreover, the land tax is much more transparent and relatively easy to calculate and to control (corruption can be minimized).

There are of course costs alongside benefits to consider in any plan, and these would need to be thoroughly analyzed and vetted. One concern, for example, towards giving preferential treatment in a tax holiday to farmers is the possible effects and reactions from other sectors of the economy. Moreover, while simplifying taxes for farmers as such should stimulate economic activity, there may be other elements more important in regard to improving productivity and output than taxes, including poor transport conditions, customs corruption, absence of marketing, poor quality of products, and others.

The VAT (Value Added Tax) may also need to be re-examined. The introduction of the VAT for larger farms has not been a success and has generated little revenue.

There is a relatively high VAT-threshold, currently set at an enterprise turnover of 24,000 Lari, and this excludes the large majority of farmers. However, the threshold is a disincentive to merge land plots or farms, and hence may stimulate farming at a sub-optimal scale in some cases. In addition, the effective exemption of the smaller farms from VAT means that they are not eligible to reclaim taxes on inputs, and that they may in fact suffer from a higher VAT burden than the bigger farmers. Hence, Georgia could consider lowering the VAT rate on certain inputs, which can only be used by farms, to zero percent, namely on irrigation equipment, fertilizers, pesticides and seeds. Again, the impact on government revenue would be minimal, but the lower priced inputs would provide some stimulus to greater productivity and production.

Recommendations:

- **Focus more attention on the impact of tax policy on the economic activity of SMEs and farmers, and seek ways to simplify the tax system to better stimulate economic activity.**
- **Endorse the importance of minimizing the number and frequency of changes in the tax code, and consider oversight in parliament to this effect.**
- **Engage in a dialogue with the IMF in Washington on how best to stimulate agriculture through tax policy. This would include consideration towards a tax holiday for farmers and a phased-in flat tax as the primary if not sole tax on agriculture. Consider the merits of the VAT tax on agriculture as well in this discussion.**
- **In concert with the IMF, bring an expert (or a team) out to assess tax policy towards agriculture.**
- **Consider working towards lowering tax penalties [Art 218(7), Art 254, and Art 273 (24) may be the most egregious (see July 10, 2000 memo from S. Hester)], and having the laws on**

tax penalties distinguish between (inadvertently) negligent behavior and willful behavior. Consider whether the interest rate for late payment of taxes can be reduced to a more reasonable level or capped, while at the same time discouraging abuse of the lower rate.

- **Work with banking reform to consider changes in the law to prevent the tax department from freezing bank accounts without adequate due process.**
- **Work towards improving access to tax information for small businesses and farmers.**

iii. Public Expenditure and the National Budget

Advisors, including the US Treasury, are working with the Ministry of Finance and Parliament to improve budget laws, forecasting ability, and the formulation and execution of budgets. This work is extremely important, not only to improve the budget process, but to improve the tax system. Inflated revenue estimations are used to create revenue targets and quotas for the tax administrators. These targets result in pressure on taxpayers to make advance payments of tax.

Two areas in particular that may need greater focus on the part of the donor community are estimating tax revenues and tracking expenditures. Reasons as to why there currently exists a low capacity in the GOG for estimating tax revenues include a lack of reliable data necessary for accurate forecasting and a lack of technical capacity for forecasting. Fragmentation of responsibility among the Ministry of Finance, Ministry of Revenue, and Ministry of Economy, Industry and Trade has also been a contributing factor. There is a need to centralize revenue forecasting responsibilities with the Ministry of Finance and for better coordination and effort on the part of US Treasury, USAID, the IMF and the World Bank.

There is also a great deal of "leakage" in the process of transferring revenue to the spending agencies and along down the line to the end recipients. Moreover, the Ministry of Finance has a low capacity for accurately tracking expenditures.

Recommendation:

- **Work to ensure that more donor attention and resources are devoted to key budget and expenditure issues. This should include helping to centralize revenue forecasting responsibilities with the Ministry of Finance and increasing its capacity to forecast revenues and track expenditures. The Government of Georgia must improve its treasury and public accounting systems to achieve adequate expenditure control.**

2. Enterprise Privatization

The Georgian privatization program has only realized limited success over the last two years. Major strategic industries have yet to be privatized with the exception of the distribution component of energy. Others such as Poti Port, the telephone company, textile, steel, fertilizer, etc. are still state owned and most are inoperative and with heavy liabilities to the state. The steel plant, for example, has a debt of US\$60 million. In addition, the state still owns residual shares in up to 300 enterprises that have been partially privatized. These range from 10 % to over 50 % state ownership.

The Barents Group has provided consulting service to the Ministry of Privatization (Ministry of State Property) over the last two years. A cash auction system that would have quickly cleared the pool of residual state owned minority shares was never developed. Instead, Barents was directed to focus on nine strategic enterprises utilizing a complex, politically controlled, carve-up approach to privatization. The approach seeks to split each large industry into separate operating units and privatize as a stand-alone unit with a foreign investor or outside domestic investors. This approach has not worked in the NIS countries and the Barents team stated that there was limited opportunity, if any, of this approach working in Georgia.

Moreover, the overall privatization program has failed to resolve two policy issues that have traditionally limited enterprise privatization in Georgia.

- First, most enterprises have debt to the state that investors are unwilling to absorb when purchasing a state owned enterprise through the privatization program.
- Second, the Government continues to offer enterprises for sale based on the old soviet book value which is many times over the market value. Only after five tender offers, will the Government consider a price under the book value. This complex approach is precluding the privatization of enterprises.

Recommendations:

- **That the Barents privatization assistance be terminated at the completion of the current Task Order in September.**
- **That future privatization assistance take the form of cash auction through the capital markets. However, assistance to implement a cash auction would only be provided after resolution of the above two policy issues.**

3. Land Privatization

a. Land Ownership/Property Owners' Rights

By the end date of the current task order on September 15, 2000, the USAID Land Privatization Project expects to have assisted in the registration of approximately 1,000,000 non-residential agricultural land parcels. Registration is near completion in 20 of the 38 raions being supported by the USAID Land Project. The Project has also assisted in the privatization of enterprise land for approximately 6,500 out of an estimated 10,000 privatized and newly-formed private enterprises throughout Georgia that have land. Of the remaining enterprises, many are not operating or viable

and therefore do not have the resources or incentive to privatize their land.

The Land Project's organizational framework and system for surveying and registering the private land is effective and should be continued at least through year-end 2001. By that time, the project anticipates completion of the surveying and registration of 3,000,000 non-residential, agricultural parcels that were distributed in the first round of privatization. Achieving these targets will require either an extension of the current task order or establishing a new task order. In either case,

responsibility for managing the Land Project could be shifted to a Georgian NGO with a gradual phase-out of expatriate consultants, as long as there is a clearly defined transition/ development strategy for the local NGO (see recommendations below).

The current composition of the Land Project, as managed by Booz, Allen and Hamilton, includes a central organization comprised of the following teams:

- Legal regulatory team (4 people) that advise and lobby the Parliament and Chancellery on legislative and policy issues;
- Transaction team (3 people) that trains and coordinates real estate subcontractors who facilitate enterprise land privatization/registration and secondary transactions of agricultural land; and
- Agricultural Land Registration Team (15 people) that trains and coordinates the surveying contractors who prepare all cadastre and map documentation necessary for the registration of privatized land.

The project has been effective in setting up private companies that provide contractual services to carry out surveying, registration and secondary transaction activities. To date, 35 surveying companies with approximately 1,200 contractors and 5 real estate brokerage companies with approximately 75 contractors have been formed. Many of these companies will become commercially viable as the land market develops.

Other functions of the Land Project have already been transferred to the Association for the Protection of Land-owner Rights (APLR), though funding for the associated salaries and activities continue to be provided through the Land Project. Specifically, the manager of public education and media relations activities is now part of the Association staff, as is the lawyer who manages the regional outreach efforts. The Land Project funds and the Association oversees the activities of regional offices in Kutaisi and Telavi, and ten other individuals who cover separate regions throughout Georgia. These outreach teams resolve potential conflicts and provide information to landowners. The Association also runs a telephone information line. Since June, the central and regional offices have received 1,000 calls from individuals seeking information on their rights, advice/mediation in resolving a conflict or assistance in registering their land.

Recommendations:

- **Land project: Continue to support the Land Project efforts in the registration of agricultural land to a total of 3,000,000 parcels. Shift responsibility for the Land Project into the Association for Protection of Land-owner Rights (APLR). The current configuration and management structure of the Land Project should be maintained with the following possible adjustments:**

- (1) The transaction team could eventually be downsized from 3 to 2 people.
- (2) Encourage the development of more raion-level real estate broker/facilitators through training by the Land Project's transaction team manager.
- (3) Develop a 6-9 month transition plan that will allow for the gradual ramping

down of payments to real estate brokers for enterprise land privatization transactions, while allowing them to begin charging for their services. Transition from donor support to fee for services on agricultural land transactions should be more gradual—over 1½ - 2 years, depending on whether the project is extended to support registration of the current state leased and unallocated land.

- (4) The Legal/Regulatory team should continue to work with the Parliament and Chancellery to develop appropriate legislation.
 - (5) The APLR continue and possibly expand its outreach efforts through the Association's hotline and regional legal/public information outreach teams.
 - (6) Maintain the current size and configuration of the surveying team and encourage the cost-sharing purchase of surveying total stations for the surveying companies (30-40 @ 1/2 of \$8000 each).
- **Association for the Protection of Land-owner Rights:** Either Booz, Allen Hamilton or a newly-contracted, western NGO could provide financial oversight and advise APLR during a transitional period of approximately 18 months. From the outset, there should be a transition strategy with a clearly defined schedule for APLR to assume responsibility for financial management of the project. During this transitional phase, APLR will also develop a long-term strategy for institutional development and commercial viability. This strategy should emphasize integration of other groups such as real estate brokers and surveyors into a unified association.

b. Distribution of State Unallocated and Leased Land

There is growing consensus among government and parliamentary representatives that the state-held leased and unallocated arable land should now be privatized. Privatization advocates disagree, however, on the methods for distributing the land. Distribution plans vary depending on whether more weight is given to social equity or commercial viability concerns.¹ Elements of the distribution plans include:

- Recipients—The spectrum goes from a mass distribution of small parcels of land to a selective distribution that gives priority to current leaseholders; zero auctions for non-lease holders are considered a means to distribute unallocated land in the latter case.
- Price and system of distribution— Most land privatization advocates suggest using some multiple of the land tax in direct sales to leaseholders for their leaseholds. [Land tax X 10 is currently being promoted by the State Department of Land Management (SDLM) and APLR]. Land remaining after the time limit would be added to unleased arable state land to form the pool for an auction. The auction would be open to the remaining rural residents, with suggested limitations according to residency (i.e., by village, raion, etc.). Distribution free-of-charge is not considered politically feasible, as the GOG is seeking some revenue from this privatization.

¹ For a good discussion of the advantages and disadvantages of various alternatives for privatizing state-held arable land, see the memo dated May 26, 2000 by Bob Cemovich, chief of party for the Land Project.

- Timing of distribution and of payment—SDLM supports the honoring of leases, even if those leases are for 10 or more years; APLR and the head of the Economic Reform Committee are willing to break the leases, as long as leaseholders are given priority to purchase their leaseholds. They suggest a time limit for these priority purchases.

There are approximately 958,000 ha. of leased land and 183,000 ha. of unallocated (non-leased) arable land, according to government figures. The remaining unallocated land is pastureland.

Representatives of the SDLM are suggesting that this unallocated pastureland be left in state control. In this way, many rural households that depend on the state-held pastureland for grazing their livestock retain access. If the unallocated pastureland remains in state control, the pool of land available for this second round of privatization amounts to 1,140,500 ha. of which approximately 84% is leased.

According to Overseas Strategic Consulting's (OSC) recent survey, the majority of leased land is held by farmers who lease less than 200 ha each. Moreover, the survey found little evidence of subleasing. This dispels the common assumption that many leaseholders are land speculators who control vast estates. However, only 15% of the rural population are leaseholders. There are obvious social equity issues associated with strategies that will give 15% of the population priority access to 84% of the land to be privatized in this round.

The goal of this privatization is to move arable land out of the public sector. While the first round of privatization was intended to ensure each rural household received a parcel of land, most agree that this round is intended to create viable, commercial-scaled farms. The simplest way to do this is to give priority purchase rights to the current leaseholders. However, this strategy will effectively exclude 85% of all rural residents from access to 84% of the land to be privatized in this second round. Many Parliamentarians support a strategy that gives priority to leaseholders. Many Parliamentarians are also themselves leaseholders.

Since leaseholders are often perceived as those who used connections or political clout to gain control of the best state-held land, a strategy that gives leaseholders priority access to the majority of land in this phase of privatization may be unpopular with a large percent of rural residents. However, many leaseholders have also made investments in their leased land and are likely to be quite vocal in their opposition to any strategy that would deprive them of what they perceive as their land.

Use of the land tax as a determinant of the base purchase price may also raise objections. Some claim that land tax does not accurately reflect the variability of land quality (i.e. irrigated land vs.

land with non-functioning or no irrigation). The Germans and many in the SDLM take this even further and want to conduct a soil survey to determine the quality of the land. If the distribution were dependent on this soil survey, it would slow the process and raise the cost significantly.

The OCS survey shows 47% of the rural population disagree with the government's current direction on agricultural reform. Although it is likely that this dissatisfaction is based on erroneous assumptions or lack of information, it should not be dismissed. Whatever distribution strategy is adopted for privatization of this land, efforts should be made to expand public understanding and build public support for this program.

Recommendations:

- **Provide assistance to the Parliamentarians (Heads of the Agricultural and Economic Reform Committees) and the Ministry of Agriculture in their efforts to adopt a clear policy for the privatization and registration for the remaining arable land in state control.**
- **The policy/approach supported by USAID should include elements that are quick, transparent and promote the formation of commercially viable farms. Therefore, priority should be given for a limited time to current leaseholders to purchase their leaseholds for some multiple of the land tax. Use of normative prices should be discouraged. Instead, whenever possible, price information on land sales and leases could be used as an indicator of the market value of land. After the set time for leaseholder purchases has expired, a Dutch or zero auction could be held to distribute the remaining leased land and any land that has not been held under lease (unallocated land).**
- **While this approach to distributing unallocated and leased state land emphasizes commercial viability, integration of elements that would increase social equity should also be considered. For example:**
 - **a shorter timeframe for priority purchase by existing leaseholders (6 – 12 months) and higher initial purchase prices may increase the pool of land available for auction to the rest of the rural population.**
 - **There have been rumors of selective purchase financial assistance to leaseholders for purchase of land. This should be discouraged.**
 - **Prior to the vote on the law that will determine the strategy for privatization, Parliamentarians could be asked to disclose the amount of land they and their immediate family control.**
- **APLR should hold more meetings throughout the country to inform rural residents of the draft legislation and solicit feedback from them on this issue. The Association should hold some meetings at village level. Every effort should be made to more actively engage participants in a discussion of the process as outlined in the draft legislation. Other outreach vehicles should also be employed. The goal is to promote better understanding of the process by rural residents, solicit feedback, and build public support for the policy.**
- **Assist GOG to develop and implement the privatization of state leased and unallocated land through APLR or another independent contractor. Depending on the strategy adopted, this could entail running auctions or conducting other elements of the distribution. Assistance with registration of these parcels could also be considered, but may conflict with the German intentions to survey all leased and unallocated land currently held by the state.**

c. Consolidation of Agricultural Land

During the first round of agricultural land distribution in 1992-99, rural households received ownership of various types of land—their residential/household garden plots, arable land and vineyards—totaling a maximum of 1.25 hectares for each household. This distribution process provided that each rural household would have access to various types of land, but also led to a fragmentation of agricultural land. This fragmentation often precludes the use of equipment as owners of adjacent small plots often plant different crops. Moreover, arable land and vineyards are often not conveniently located. The OSC survey showed that 35% of farmer/peasants have plots that are 4-10 kilometers from their homes, and more than 10% have plots over 10 kilometers away. Since most rural residents don't have ready access to transportation, tending these crops can be difficult.

Consolidation of agricultural land will allow the formation of viable farms that are scaled for use of agricultural equipment. Consolidation of parcels will also address the impracticality of a farmer trying to cultivate several small parcels that are convenient neither to his home nor to each other.

The German organization KfW intends to conduct a pilot project under the DM 30 million loan approved by Parliament earlier this year. They intend to encourage consolidation through unspecified, non-market approaches. According to the KfW representative, such consolidation would be based upon soil quality evaluation. This process would be time-consuming and costly if rolled out across Georgia, and could significantly delay the development of land markets. USAID supports consolidation of agricultural parcels through land market development. That said, land markets in Georgia remain significantly constrained at present. There have been some secondary transactions, including 1,153 registered parcel sales and 25 registered leases. But according to the Land Project transaction team, approximately 40% of these secondary sales are to people from Tbilisi. Few rural residents have the liquidity to purchase land outright.

Moreover, credit is not available to finance land transactions since interest rates are too high, and most banks will not currently lend to the agricultural sector. In order to discourage speculation and encourage retention of land assets by rural residents, the Land Project has shifted its emphasis from promoting sales to promoting land leasing. This approach enables some initial consolidation in the face of a tight credit market.

Ultimately, vibrant agricultural land markets are contingent on a vibrant agricultural sector. Producers will not seek to expand their land holdings unless they have access to markets for their produce and are able to pay their taxes. The tax reform and market-linkages programs recommended elsewhere in this report will contribute significantly toward stimulating agricultural sector development. However, there are some activities that could be undertaken to promote land market

development in the interim.

Recommendations:

- **Develop credit mechanisms by:**
 - **Strengthening linkage between the Land Project real estate consultants and existing USAID credit programs;**
 - **Providing training to both real estate consultants and credit union/association loan officers on purchase price mortgage lending;**

- **Exploring uses of the Loan Portfolio Guarantee through the Global Bureau's Credit and Investment office to support land market development programs;**
- **Continue to promote an environment more enabling of land market development. Specifically, lower registration fees (currently GEL 26 per parcel) and notary charges (currently 1-3 % of the transaction) on all subsequent transactions. Consider privatization of registration offices; or promote adoption of a policy that would allow registration offices to retain some or all of their collected fees.**
- **Expand support for and tracking of secondary transactions, including rental and sale price information; consider developing a mechanism for distributing land market information and advertising land for sale or lease.**

4. Financial Markets and Corporate Governance

The capital markets and accounting programs began in January 1997. The infrastructure for these two industries and oversight bodies are in place and all are operating in a start-up phase.

a. Capital Markets:

The capital markets component includes: The National Securities Commission of Georgia (NSCG); The Georgian Stock Exchange (GSE); a depositary; eight independent share registrars licensed by the Commission and thirty-four licensed brokerage companies. The mass privatization program created 363 private enterprises with 100 shareholders or more which could be listed on the GSE. To date, 99 are listed and can begin trading.

One innovative approach to the Georgian capital markets is found in the NSCG. Two foreigners were selected as NSCG commissioners (an American and an Australian). The five-member commission elected the American as Chairman. In less than three months, this composition has already begun to force discipline and transparency for industry participants.

The one missing element of the capital market infrastructure is the absence of investment funds that were created in the other NIS countries through the mass privatization program. These funds were never allowed to emerge as a major participant in the Georgian mass privatization program due to

government fear of corruption and a lack of vision as to their future role in a market economy. In the other NIS countries, these funds have evolved into investment/venture capital funds. They are now playing an important role in replacing old "red managers" with young entrepreneurs who are beginning the process of enterprise restructuring. The absence of these funds in Georgia will make the enterprise restructuring process more difficult, but the process must continue in their absence.

b. Accounting

The accounting infrastructure now has the foundation for shifting from the Soviet accounting to conversion to International Accounting Standards (IAS). This includes:

- the legal and regulatory framework (although the Government still needs a law to move

certification of auditors out of a state agency and into an industry association);

- an audit and accounting association that has a charter and accompanying legal authority to function as a self-regulatory organization (SRO);
- curriculum reform including the capacity to offer training in the Association of Certified Charter Accountants (ACCA) program; and
- two oversight bodies that will have some authority over the accounting profession. They are the Chamber of Control, housed in the Parliament and the National Securities Commission of Georgia.

The Georgian Federation of Accountants and Auditors (GFAA) is one of the only two SRO's in the NIS to be accepted as full member to the International Federation of Accountants and Auditors (IFAC). The GFPAA and its members will be primarily responsible for the conversion of both financial and managerial accounting in industries and businesses throughout Georgia. In addition, the GFPAA's English language ACCA program has been underway since 1999 and currently has 125 students at various levels of completion. Upon graduation, these students will become new entrepreneurs and managers in business and industry.

The objective of the next phase of market reform activities is to move the present infrastructure of oversight bodies and industry participant to an implementation outreach phase. In the outreach phase, oversight bodies would be fully capable of enforcing transparency and corporate governance. Self-regulatory organizations would become financially viable and demonstrate the capacity to regulate their members thus limiting the government's oversight role. Finally, industry participants would move from a start-up phase to commercially viable enterprises through TA-supported enterprise restructuring activities.

Recommendations:

- **That the current discreet capital markets and accounting projects be combined into a single activity over the next two years with a primary focus on sustainability and the creation of good commercial business practices founded on sound corporate governance. Specific illustrative recommendations are to:**
 - **Move the capital market and accounting SROs to commercial viability.**
 - **Complete the first round of ACCA training.**
 - **Build the capacity of the private audit and accounting enterprises with the skills to restructure enterprises for a fee.**
 - **Build the capacity of investment funds and dealer brokers to assist in restructuring enterprises through better management and the raising of capital through IPOs.**

5. Banking Reform

a. Banking Environment

In common with many other countries of the former Soviet Union, the Georgian banking sector plays a limited role in savings mobilization and in lending to efficient private sector businesses. The reasons are familiar - - high real interest rates, insider and related party lending, difficulty valuing collateral, among other things. And fundamental, is the poor economic performance. Vigorous economic growth (so crucial for rapid banking sector expansion in countries such as Poland), although not a panacea, is a necessary condition for increasing the role of the banking sector in financial intermediation.

Given the outlook for the economy and government policies described in other parts of this paper, it is likely that discernable improvement will become evident only over an extended period. For the foreseeable future, banking opportunities are sharply circumscribed, given the economic and political context in Georgia. USAID's technical assistance program is calibrated to this reality.

In the current environment bank lending to the private sector cannot be jump-started by, for example, credit lines to banks (and, in fact caution is advised, least these well-intentioned efforts set up incentives for banks to ignore prudential concerns). What USAID is emphasizing is the need to develop the basic building blocks of the banking infrastructure -- to lay the foundation.

Starting as Georgia is from virtually the beginning, this is an extended effort. But these efforts will pay off in time because a well-regulated banking system, with good information and systems in place to assess the financial conditions of banks, not only builds public confidence in the banks as a depository for savings, but gives bank management the ability to allocate investment by market criteria.

b. USAID Banking Assistance Program

The specific elements of the USAID technical assistance program are:

Bank Supervision: There are basically three guarantors of the safety and soundness of the banking system -- the market, the management and owners of the bank, and the government's regulatory authority. In a nascent banking sector market forces are weak, and management too often unable or unwilling to exercise prudent authority. Thus the task falls overwhelmingly on the shoulders of an

ill-prepared central bank supervisory authority. Since October 1999 USAID, in collaboration with the IMF, has provided technical assistance to the National Bank of Georgia (NBG) Bank Supervision Department. Although some of the rudiments are in place, the NBG Supervision Department is still very much in the first stages of its development.

Regulatory Infrastructure: An important bottleneck currently for the efficacy of NBG Bank Supervision is an inadequate NBG regulatory structure. In July 1999 USAID fielded a regulatory lawyer who will develop a new set of regulations, consistent with international standards. These will give NBG Bank Supervision enforcement powers needed to act aggressively against recalcitrant banks.

Accounting Reform, Bank Risk Management and Internal Controls: The second critical bottleneck to better bank supervision and more rigorous bank risk management is poor information because Georgian banks are not converted to international accounting standards (IAS). The way

accounting is done in the commercial banks not only gives the NBG flawed information, but also gives bank managers and owners a distorted picture of their bank's financial health. Georgia is decidedly behind many other countries of the former Soviet Union, most of who converted to IAS during the late 1990s. IAS conversion is scheduled for January 2001. In June 2000 USAID brought an experienced central and commercial bank accountant to work with the NBG in guiding this difficult IAS transition. Two more accountants will join the team to work with banks early next year when EU Tacis assistance ends.

Electronic Funds Payments System: Another critical element of the banking system is the execution of the electronic funds payment system. Processing payments in a timely, efficient manner is as important to the development of a dynamic, private banking environment as is its funding. Before the end of 2000, a three-year USAID funded effort should result in a new, highly efficient, real time gross settlement system, greatly increasing the efficiency of the payments mechanism.

Bankers Training: In Georgia bankers still do not have well developed professional skills nor, given the environment, are they being schooled in prudential concerns. USAID has supported a bank training facility for over two years, whose objective was to become a self-sustaining entity after USAID assistance was withdrawn in December 2000. Suffice it to say from hindsight there were problems in both the design and the delivery of this assistance. The current plan is to merge the bankers training effort into a broader financial services training facility, along with other capital market entities, housed within a broader, already self-sustaining institution, such as a university. This approach will minimize fixed overhead costs.

c. Looking Ahead

The ultimate objective is a banking sector which performs well the basic functions necessary for economic growth -- mobilizing savings, funding efficient private sector businesses, transmitting government monetary policy, and efficiently executing the payments system. Given the current economic trajectory touched on earlier, it is unlikely that by the end of the present Bank Supervision Task Order in early 2002, the situation will be dramatically different.

What could, however, realistically be expected during this time is a decided improvement in the prudential regulatory environment, which should by then be largely consistent with international standards and empower NBG supervisors to carry out their prudential responsibilities. Moreover, there should also, gradually be an improvement in reporting by the banks as the IAS methodology becomes more entrenched.

Improvements in the legal and accounting areas will greatly enhance the NBG's ability to perform a better financial assessment of the banks. Starting in 2001 there should be consolidation of the banking system and further reduction in the number of banks since banks' ability to hide losses through creative accounting and/or hide behind poorly written laws and regulations will be sharply circumscribed.

Bank managers too should have a better grasp on the financial condition of their entity although a more extended period will be needed for the revamped accounting methodology to be applied in banks to upgrade risk management and internal controls and procedures. Finally, over the next year a

solid beginning should be evident in developing a sustainable, professional training center that services different facets of the financial community, including banking.

In addition, there are important ancillary impediments to efficient bank lending. In particular, the commercial law framework, particularly with respect to securing obligations, realizing collateral, and the rights of secured creditors contains gaps, vague provisions and conflicts. The resulting substantive and procedural difficulties, combined with weak institutions (e.g., judiciary, bankruptcy administrators, execution services), renders lending transactions, including exercising legal rights - lengthy, expensive and uncertain. Increased judicial competency remains an acute need, including to assist the implementation of reforms in banking, capital markets and land privatization and to better ensure parties to agreements that their rights will be protected in accordance with law. The absence of a collateral registry system for recording liens on non-real estate property, that is a basic element of successful bank intermediation and is contemplated by the Civil Code, causes particular uncertainty as creditors cannot determine that collateral is clear of other liens and must use inefficient practices to address this information gap.

Recommendations:

- **USAID/Georgia should continue to support the banking reform program.**
- **The focus should continue on integrating bank accounting training with other parts of the overall USAID accounting program implemented through the Georgian Accounting Association (recognizing the specialized training that bankers will additionally need).**
- **In addition to the bank specific work in developing western-based accounting methodology in the banks, auditing and accounting firms that are members of Accounting Association should also receive training to develop their specialized skills in the banking area.**
- **Finally, USAID/Georgia should provide modest additional support for the implementation of commercial laws. This would include legal assistance and providing practical guidance to reduce impediments to lending and secured transactions, judicial training on select topics (including preparation of commentaries and handbooks on select priority topics and, subject to fund availability, technical assistance to support the creation of a collateral registry.**

6. Restructuring the Ministry of Agriculture:

With over 4,000 employees, the Georgian Ministry of Agriculture is currently structured, organized and staffed to carry out soviet style command and control activities throughout the agricultural sector. Severe budget constraints over the past several years have resulted in some downsizing in the Ministry and many previous functions and activities are no longer being carried out. However, an inappropriate structure remains, overstaffing continues and clear lines of responsibility, transparent practices and fund accountability are lacking. The Ministry cannot and should not operate as it did in the past, but it is not organized or staffed to perform the functions needed in the future.

The new Minister of Agriculture has recognized the necessity of restructuring the Ministry to meet the needs of a market-driven agricultural sector and has requested foreign assistance in doing so. This implies down-sizing the Ministry in terms of both personnel and assumed responsibilities as well as

restructuring to enable the Ministry to implement policy-making, regulatory, monitoring and other appropriate responsibilities effectively.

Assistance to the Ministry of Agriculture's restructuring would directly support one of the four key points in the U.S.-Georgian Four Point Program: civil service/public administration reform. While it is entirely appropriate, and possible, for USAID to focus accelerated reform assistance to this ministry, the initial planning will have to ensure that the Minister will receive the political support necessary to overcome the present across-the-board legal and regulatory impediments to rightsizing the public sector.

This impetus for reform at the Agriculture Ministry is doubly fortunate for USAID/Georgia as well as Georgian farmers, laborers, investors and consumers. First and foremost, it will position the Government of Georgia to take maximum advantage of the country's substantial potential to prosper from wise use of the country's remarkable endowment of food and agricultural products. (More on this central economic growth opportunity in the section on strengthening the market chain -- Section B -- below.) Second, the Ministry of Agriculture, like the Tax Administration, could serve as a relatively manageable first step toward focusing and streamlining the entire Georgian public sector.

Recommendations:

- **Respond to the Minister's request and provide limited technical assistance on a phased basis, including expatriate and Georgian expertise, to support the downsizing and restructuring of the Ministry of Agriculture. The assistance should focus on:**
 - **determining the functions the Ministry should continue and developing policy, strategy and implementation plans for downsizing the Ministry in terms of staff and responsibilities;**
 - **developing a strategy and plan for the transfer to the private sector of selected Ministry assets and functions;**
 - **providing policy advice on day-to-day issues affecting the agricultural sector.**

- **The assistance should be provided in two phases. The first phase would be for three months with the second or follow-on phase extending for 24 months. Implementation of Phase II would be conditional on results achieved during Phase I and agreement with the Minister of Agriculture, as reflected in a Memorandum of Understanding, on the exact role and expectations for the USAID provided assistance during the Phase II period. The Phase II plan should be approved by USAID and the Ministry of Agriculture prior to proceeding with implementation of Phase II.**

B. Strengthening the Market Chain

The Assessment Team is unanimous in concluding that this is the perfect time for USAID/Georgia to put considerably greater effort into resolving the distortions and market failures that beset each link in the product-to-consumer "value chain." Without such direct, "hands-on" assistance, Georgians may have to pay an unacceptably high price in time and human

misery while waiting for local entrepreneurs to take full advantage of the market opportunities offered by a liberalizing economy.

In short, a "bottom-up" initiative is needed to complement the primarily "top down" strategy USAID/Georgia has employed to date.

The bottom-up element of the strategy has in fact already begun, through USAID/Georgia's (and various other donors') numerous micro- and small/medium-enterprise promotion activities. Arguably, the two existing ACDI/VOCA activities (to build up a local seed industry and to establish farmer credit cooperatives) embody many of the characteristics of this bottom-up approach. A key to these efforts' success will be linking the productive potential of micro- and small-scale enterprises (including farms) with the demand for their products and services which must come "at least in great part" from larger wholesalers, processors, shippers, exporters and retailers.

The team is confident that, if any single sector stands out as possessing the potential to stimulate broad-based growth in Georgia, it is agriculture and its related complex of industries. The two final sections of this report propose a new agribusiness/farmer outreach activity, as well as related adjustments to the Mission's comprehensive new micro-small and medium enterprise program.

1. Agriculture and Agribusiness

a. Background

From almost any perspective the agricultural sector's current role in the Georgian economy is vital. In 1999, the sector (including agro-industry) contributed over 33 percent of GDP, or more than twice as much as any other sector. Employment in the sector is estimated to make up over 50 percent of total employment. Agricultural exports ranked second to metals in 1999 providing over 17 percent of total exports¹.

But these current figures may also be somewhat misleading. Agricultural output is down at least 30 percent since 1990 and labor productivity in agriculture has fallen even further as the sector has become the source of employment for thousands of unemployed from other sectors. The capital stock of farm machinery and processing equipment is generally in extremely poor condition. Food, drink and tobacco imports exceeded agricultural sector exports in value in 1998² while the production of value added products such as grape wine and canned food items using domestic raw materials has continued to fall. Most of the old state processing facilities no longer operate. Agricultural input use now is but a miniscule fraction of 1980's levels.

The troubled state of the agricultural sector reflects the need for action to resolve numerous constraints impeding market reform. The lack of tax reform, tolerance of smuggling and customs irregularities, the unavailability of financing and incomplete enterprise privatization and restructuring have created a situation where enterprises barely operate or are closed down. Of the 30 enterprises visited by the team, over 90 percent were closed and only a few of the remaining companies were operating at more than 10 percent of capacity. At the farm level the effect of this

¹ The source of these numbers is the IMF Report of April 7, 2000.

² Latest year for which data is available.

situation is a slide into subsistence production. If these issues are not addressed now, and with a sense of urgency, we can only expect the situation in agriculture to grow progressively worse.

Nevertheless, the assessment team believes there are real, quick pay-off and longer-run opportunities for positive developments and market-led growth in the sector. Georgia has the production potential to reduce import levels of some crops with domestic production (milk and wheat products) and to increase exports of higher, value added products that will expand internal markets for current and expanded domestic production of grapes, fruits and nuts in particular. The keys to success are a supportive business environment in Georgia and specific activities that will encourage local (and perhaps foreign) investment in viable production, processing and marketing activities.

b. USAID Agricultural Assistance

USAID assistance to the agricultural sector, excluding land reform, has been modest. Earliest assistance was in the context of humanitarian aid and included provision of maize, wheat and potato seed, training and farmer-to-farmer volunteers. Internally Displaced Persons (IDPs) and small farmers in selected geographic areas were also targeted with inputs, credit, training and technical assistance³. Finally, a U.S. investor in wine processing received a small grant to cover a portion of the technical assistance, management and initial operating costs involved in the establishment of a joint venture.

More recently, through a grant to ACDI/VOCA, USAID has supported the development of the agricultural seed industry (wheat, maize, sunflower and potatoes) and the establishment of agricultural production credit associations. Under the seed industry assistance, a private seed company has been established that is currently producing and marketing potato, maize, wheat and sunflower seed. Limited continuing assistance to the company aimed at increasing its financial viability will end on September 30, 2001.

With USAID assistance, six production credit associations have been successfully established by ACDEI/VOCA and over \$900,000 in loans is currently outstanding. The repayment rate is almost 100 percent. USAID support for this activity will end September 30, 2000.

c. Problem Areas Facing the Agricultural Sector

(1) Policy

The agricultural sector suffers from the same set of constraints to an enabling business environment as do other sectors of the Georgian economy. Tax reform, customs reform, land

³ Several NGO's continue to provide assistance to small farmers in specific geographic areas, often using funds from the monetization of USDA provided commodities.

reform, banking reform and other market reform requirements are critical if the agricultural sector is to grow.

Recommendation:

- **See other sections of this report for specific recommendations in each of these reform areas.**

(2) Farm Level Marketing

Under the previous system, marketing was handled largely by the state. This system no longer functions, and alternatives have been slow to develop leaving local producers with no readily accessible markets. The major decline in the processing industry (see below) has also meant a lowering of demand for some products (grape juice in particular). Surpluses of many fruits, vegetables and milk at the local level were evident to the assessment team and confirmed by local producers. A limited number of efforts to provide a market for village production are emerging. The Team visited a milk collection site in Dedoplistskaro, Kakheti that is serving 500 farmers. This product/market chain has put cash in this rural community and encouraged production and input use.

Recommendation:

- **Develop output market channels and strategies such as village collection points or local produce grading for specific markets. Contract relationships between processing plants and producers would be another method of providing markets.**

(3) Agricultural Input Supply

The old agricultural input supply system has largely collapsed and a new system suitable for a market economy has not yet emerged. Many inputs are no longer available, input suppliers that are active have yet to develop systems to reach small landholders, and small landowners lack resources to purchase inputs. However, the experience with farm stores of a CARE-supported activity in three districts of southern Georgia indicates that small landholders with a market for their products will buy some inputs. With other donor assistance an input ordering system organized by technical experts for mid-size farmers has worked on a modest scale in two other areas. This evidence suggests that lack of access to inputs may be the most important reason for their non-use in many areas. When farmers have the opportunity to procure inputs close to their farms they will.

Recommendation:

- **Establish a system of input supply at the village level through privately or cooperatively-owned farm stores, or through processors that are willing to provide inputs to help ensure a supply of raw materials for processing.**

(4) Processing Capacity and New Investment

Most agricultural processing facilities in Georgia are old and of a scale -- even if operating -- that makes them non-competitive. Only four of the 30 enterprises that comprise the Association of Food Processors of Imereti Region, for example, are reportedly operating, and only one of those on a regular basis. The Team visited flour mills, sugar plants, wineries and dairy processing facilities in other regions that were idle or operating at no more than 10 percent of original capacity. In short, only limited refurbishment, downsizing or new investment in the processing industry is taking place. Without additional processing investments, either local or foreign, marketing opportunities for many agricultural products will continue to be very limited.

Fortunately, there are also some good examples of local and foreign investments in a range of areas including fruit processing, flour milling and egg production that demonstrate the possibilities. A businessman privatized a large previously state-owned egg production facility, renovated part of the facility and is producing eggs for the Tbilisi market. He is looking for local sources of feed grains but expects to have to import from Russia. An investor in Kutaisi has put a flour mill back in operation, established a bakery and is getting ready to invest in a new macaroni line. He also plans to import wheat to process. Milk and ice cream producers have imported modern equipment and use imported powdered milk because local supplies of milk are inadequate.

Recommendation:

- **Encourage processing of local products through a program that combines U.S. financial and technical assistance with additional processor investment on a matching basis.**

(5) Agricultural Extension

There are very few, readily identifiable sources of new technical and market information for farmers at the village level. However, the team is not convinced, based on conversations with farmers, that a lack of information on better agricultural practices is the key constraint they face at the moment. Apple growers, grape growers and milk producers all mentioned marketing and input supply not information as their biggest problems. Efforts to create sustainable fee-for-technical service systems by other donors have met with marginal success. In one case, input supply has been added to technical information to increase sustainability and farmer interest. The ability of the GOG to pay for a field-agent based extension service is also very problematic.

Recommendation:

- **The provision of extension information should be linked to farm stores and input suppliers and not be a stand-alone activity.**

(6) Agricultural Production and Processing Credit

A myriad of credit programs funded by various sources, including over 200 operating credit unions, provide a limited number of medium and small loans. Credit is not available for most

agricultural producers. Interest rates of 15-30 percent or more under all the programs mitigate against any long-term loans.

USAID supports at least eight credit programs, including the ACDI/VOCA program. The ACDI/VOCA program was reaching over 800, mostly farmer, borrowers as of June 30, 2000. Interest rates were around 18 percent.

For agricultural processors, available sources of credit include commercial banks, the World Bank, IFC and the Agro Business Bank (recently founded by the European Commission). The USAID-funded ACDI/VOCA credit program also provides loans to small processors, but it is scheduled to end September 30, 2000.

Recommendation:

- **Take necessary action to ensure the ACDI/VOCA credit associations continue operating, perhaps under the auspices of the Agro Business Bank. Encourage any new agricultural assistance activity to work closely with the Agro Business Bank, and existing or new credit unions to identify and facilitate access to credit for producers and small landholders.**

d. Recommended Assistance Approach

While stimulating agricultural sector growth and development in Georgia will not be simple or inexpensive, the Team believes it is certainly possible and that USAID can have a significant impact. For the assistance to be effective, targeted inputs at several levels - producer, processor and exporter - are recommended. Such a multi-level approach recognizes that capitalizing on improvements in any single element of the agricultural systems chain often requires parallel improvements in other elements. The objective is to help create product market/value chains that facilitate the movement of inputs, information and agricultural products in upward and downward links between producers, processors and final distributors/exporters. (See the chart on the following page.)

Creation of such chains requires a coordinated and integrated package of assistance that addresses:

- the needs of farmers for access to markets and availability of the inputs needed to increase production;
- the requirements of processors and exporters for raw materials, and their ability to use those raw materials efficiently; and
- the ability of processors and exporters to accelerate investment.

There are four recommended elements in such an assistance package:

1. The establishment of **small farm stores** able to provide inputs and services to private farmers. These could be owned/operated by individuals, cooperatives, private companies or any mixture thereof.
2. The establishment of **service centers** that can act as wholesalers for farm stores, provide inputs directly to larger commercial farms and provide accessible markets for a variety of agricultural products at the village level via collection centers, authorized procurement agents or other mechanisms. These farm service centers would often be based around a processor or processing facility.
3. The **expansion of investment** by processors or marketing firms in new or renovated equipment and facilities. The primary focus would be on local investors with more limited emphasis on securing foreign direct investment.
4. The **development of domestic and export markets** for fresh or processed products.

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The assistance would be in the form of technical advice; grant financing on a matching basis with local businessmen, cooperatives or investors to set up farm stores, farm service centers and village collection or buying points; grant financing, again on a matching basis, for new investment by processors or marketing firms; and hands-on training. Limits would need to be set on the size of matching grants and explicit matching fund requirements established. Implementation would be via a Cooperative Agreement using Request for Applications procedures.

The Team estimates that the total cost of such a program over 3 years would be \$15-20 million. However, the program should be performance-based with a modest initial allocation of funds (\$3-4 million) with subsequent funding based on success in establishing farm stores, farm service centers, creating village collection points, encouraging new investment leading to additional domestic market demand, identifying and securing additional domestic and external markets, etc.

2. Micro and Small/Medium Enterprise:

Through both its economic reform and its humanitarian response programs, USAID/Georgia has been managing a series of US dollar and food aid local currency grants to a wide range of non-profit agencies to provide credit and business advisory services to micro, small and medium

scale entrepreneurs and farmers throughout Georgia. There are currently ten such initiatives under way. They include, among others, ADCI/VOCA (Agricultural Cooperatives Development), IOCC (Orthodox Church), UMCOR (Methodist Church), World Vision, IFRC (Red Cross), IRC (International Rescue Committee), Shorebank and FINCA, Constanta Foundation, and ADRA (Adventist Relief).

Though credit terms vary substantially, they tend to reflect market rates and average around 20-25 percent per annum. Collection rates are generally high. Most of the programs, however, have been operating for less than three or four years, and none has yet reached the stage of being self-financed or sustainable in the long term.

In part to address the sustainability problem, and also to strengthen the micro, small and medium industry (M/SME) sector more systematically, USAID/Georgia launched in early 2000 a more comprehensive program under contract with Sibley International (and various sub-contractors including the World Organization of Cooperatives and Credit Unions, WOCCU). The initiative has four principal components:

- legal and regulatory reform (via training and mobilizing concerned local associations);
- capacity building and technology transfer (by strengthening local consulting and business advisory firms and non-profit agencies);
- access to credit (through community-based savings promoted by WOCCU); and
- public education (by training journalists and advocacy groups).

The Sibley contract was signed in January 2000. The core team from Sibley International completed its baseline survey of the sector in July and is about to open the first of an expected four offices in secondary cities. Mobilization has been complicated by unexpected turnover among several key personnel, and WOCCU, as of early August, had yet to field its principal advisor.

In discussions with Georgian and expatriate managers of the various M/SME lending programs already under way, the majority noted how valuable it would be to address the more strategic needs of the sector by strengthening its legal/regulatory, advocacy, and business consulting infrastructure. There were several expressions of concern, however, that a small-scale, community-based credit union approach to savings and capital mobilization could prove problematic. In summary, two questions may be worth considering regarding the credit access component of the Sibley program:

- In Georgia's current stagnating economic and commercial environment, how helpful or substantial will village-level savings mobilization prove to be in enabling micro and small enterprise start-ups; and
- What relative priority would such an approach have compared to other investments such as generating stronger market demand for micro and small/medium enterprise products and services?

On balance, the team supports the broad-based approach to the M/SME sector that the Mission is undertaking. Its focus on agricultural and rural enterprise promotion also seems entirely appropriate. In addition to the strong emphasis on developing market/value chains in agribusiness outlined in the previous section, it would seem advantageous indeed for USAID/Georgia to continue investing in strengthening capacity in other promising M/SME sectors.

Recommendations:

- **The various considerations and questions above suggest that USAID/Georgia may wish to take advantage of the opportunity offered by WOCCU's mobilization delays to reassess the relative need for this component at this time.**
- **In a similar vein, the team noted that other USAID-funded activities in the economic reform portfolio, notably the land privatization effort, include sub-contracts to address public education and media strengthening efforts. USAID/Georgia may wish to consider consolidating this type of assistance in the hands of only one or the other of these partners.**
- **Finally, USAID and the Sibley team could consider identifying particularly promising M/SME sub-sectors (i.e.: tourism, light manufacturing of parts or components for larger industry, crafts etc.), on which to concentrate the program's efforts.**